



PUBLIC NOTICE

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FEDERAL-STATE JOINT BOARD ON UNIVERSAL SERVICE SEEKS COMMENT ON PROPOSALS TO MODIFY THE COMMISSION'S RULES RELATING TO HIGH-COST UNIVERSAL SERVICE SUPPORT

CC Docket No. 96-45

Comment Date: September 16, 2005

Reply Comment Date: October 3, 2005

1. In this Public Notice, the Federal-State Joint Board on Universal Service (Joint Board) seeks comment on the attached proposals that several Joint Board members and staff have developed. In August 2004, the Joint Board sought comment on issues referred to it by the Commission related to universal service for rural carriers and the basis of support for competitive eligible telecommunications carriers.¹ Several individual Joint Board members and staff members have recently proposed solutions for addressing these issues. These proposals are appended to this Public Notice.² We ask that interested parties provide comment regarding how each proposal addresses the goals of the Act, the Commission's universal service goals, and any other criteria or issues described in the August 2004 Public Notice. Commenters are also invited to supplement the record with respect to any additional issues or facts that have been raised since the comment period for the August 2004 Public Notice closed.

2. Pursuant to sections 1.415 and 1.419 of the Commission's rules, 47 CFR §§ 1.415, 1.419, interested parties may file comments and reply comments on or before the dates indicated on the first page of this document. Comments may be filed using: (1) the Commission's Electronic Comment Filing System (ECFS), (2) the Federal Government's eRulemaking Portal, or (3) by filing paper copies. See

¹ *Federal-State Joint Board Seeks Comment on Certain of the Commission's Rules Relating to High-Cost Universal Service Support*, Public Notice, CC Docket No. 96-45, FCC 04J-2, (rel. Aug. 16, 2004) (August 2004 Public Notice). Specifically, the Joint Board sought comment on three main issues: (1) whether the Commission should adopt a universal service support mechanism for rural carriers based on forward-looking economic cost estimates or embedded costs; (2) whether the Commission should amend the "rural telephone company" definition for high-cost universal service support to consider consolidating multiple study areas within a state; and (3) whether the Commission should retain or modify section 54.305 of its rules regarding the amount of universal service support for transferred exchanges. *Id.*

² "The State Allocation Mechanism: A Universal Service Reform Package", proposed by Joint Board Member Ray Baum, attached as Appendix A; "Three Stage Package for Universal Service Reform", proposed by Joint Board Member Billy Jack Gregg, attached as Appendix B; "A Holistically Integrated Package", proposed by Commissioner Robert Nelson, attached as Appendix C; "Universal Service Endpoint Reform Plan (USERP)", proposed by Joel Shifman, Peter Bluhm and Jeff Pursley, attached as Appendix D.

- **Electronic Filers:** Comments may be filed electronically using the Internet by accessing the ECFS: <http://www.fcc.gov/cgb/ecfs/> or the Federal eRulemaking Portal: <http://www.regulations.gov>. Filers should follow the instructions provided on the website for submitting comments.
 - For ECFS filers, if multiple docket or rulemaking numbers appear in the caption of this proceeding, filers must transmit one electronic copy of the comments for each docket or rulemaking number referenced in the caption. In completing the transmittal screen, filers should include their full name, U.S. Postal Service mailing address, and the applicable docket or rulemaking number. Parties may also submit an electronic comment by Internet e-mail. To get filing instructions, filers should send an e-mail to ecfs@fcc.gov, and include the following words in the body of the message, "get form." A sample form and directions will be sent in response.
- **Paper Filers:** Parties who choose to file by paper must file an original and four copies of each filing. If more than one docket or rulemaking number appears in the caption of this proceeding, filers must submit two additional copies for each additional docket or rulemaking number.

Filings can be sent by hand or messenger delivery, by commercial overnight courier, or by first-class or overnight U.S. Postal Service mail (although we continue to experience delays in receiving U.S. Postal Service mail). All filings must be addressed to the Commission's Secretary, Office of the Secretary, Federal Communications Commission.

- The Commission's contractor will receive hand-delivered or messenger-delivered paper filings for the Commission's Secretary at 236 Massachusetts Avenue, NE., Suite 110, Washington, DC 20002. The filing hours at this location are 8:00 a.m. to 7:00 p.m. All hand deliveries must be held together with rubber bands or fasteners. Any envelopes must be disposed of before entering the building.
- Commercial overnight mail (other than U.S. Postal Service Express Mail and Priority Mail) must be sent to 9300 East Hampton Drive, Capitol Heights, MD 20743.
- U.S. Postal Service first-class, Express, and Priority mail should be addressed to 445 12th Street, SW, Washington DC 20554.

People with Disabilities: To request materials in accessible formats for people with disabilities (braille, large print, electronic files, audio format), send an e-mail to fcc504@fcc.gov or call the Consumer & Governmental Affairs Bureau at 202-418-0530 (voice), 202-418-0432 (tty).

3. In addition, one copy of each pleading must be sent to each of the following:

- (1) The Commission's duplicating contractor, Best Copy and Printing, Inc, 445 12th Street, S.W., Room CY-B402, Washington, D.C. 20554; website: www.bcpweb.com; phone: 1-800-378-3160;
- (2) Sheryl Todd, Telecommunications Access Policy Division, Wireline Competition Bureau, 445 12th Street, S.W., Room 5-B540, Washington, D.C. 20554; e-mail: sheryl.todd@fcc.gov.

APPENDIX A

The State Allocation Mechanism A Universal Service Reform Package Proposed by Joint Board Member Ray Baum

This package proposes a six step transition over four years to a State Allocation Mechanism ("SAM") for the distribution of Federal Universal Service High Cost and Lifeline/Linkup Funds. Before describing the transition, however, it is useful to describe the permanent plan, which would be in effect beginning in June of 2009.

A. The SAM

Beginning in June of 2009, the FCC would make allocations of Federal Universal Service High Cost and Lifeline/Linkup Funds to accounts for each State maintained by the Universal Service Administrative Company ("USAC").

Each State commission would be allowed to determine the distribution of its allocation to Eligible Telecommunications Carriers ("ETCs") in its State. State distributions to ETCs would be subject to FCC guidelines and review to ensure compliance with §254 of the Communications Act. The FCC would act in the place of any State that did not perform this role or is found to be out of compliance with the FCC guidelines.

Participating States would also have responsibility for ongoing oversight to ensure accountability for the use of Universal Service funds.

USAC would remain as the administrator of the Universal Service funds. Fund contributions would still be made to USAC and disbursements would be made by USAC directly to ETCs, pursuant to the distribution decisions made by State commissions.

A participating State would be allowed to support its own additional universal service efforts by adopting an increment to the Federal funding mechanism applicable only to consumers in its State, with the proceeds accruing to the State's account at USAC.¹ The distribution of these funds would not be subject to FCC guidelines and review.

1. The Allocation Method

The method for allocation of Federal Universal Service funds to the State accounts at USAC would be established by the FCC. The method could be based on factors such as:

1. the results of a cost model of either embedded or forward-looking costs for the most efficient technology;

¹ This provision would take effect if and when the FCC shifts from an interstate revenues contribution base to a non-jurisdictional contribution base such as telephone numbers or connections.

2. a rate benchmark designed to meet the affordability and reasonable comparability requirements of §254, described in more detail below;
3. the intercarrier compensation reform plan adopted by the FCC; and
4. the number of consumers in the State that are eligible for Lifeline and Linkup support based on federal criteria.

It is sometimes assumed that cost models are necessarily based on forward-looking economic cost ("FLEC"), but this is incorrect. It is no more difficult, and arguably easier, to construct an embedded cost model than a FLEC model. As an example, average schedules have long been used in the telephone industry for a variety of intercompany compensation purposes. Use of a cost model to determine cost allocations to the States is therefore independent of the decision as to whether to use FLEC or embedded costs. Many of the advantages of models occur whether the cost model is based on FLEC or embedded costs, such as the maintenance of incentives for efficiency, ease of administration, etc.

All models involve error, even if they are correct on average. Experience with the current FCC FLEC model suggests that it involves relatively large errors for particular wire centers. This is not a problem when the model is applied to a carrier with a large number of wire centers, but, when the model is applied to carriers with few wire centers, the errors become a more serious problem.

Applying a model on a statewide basis is a good way to manage unavoidable error. The errors will tend to cancel out across the wire centers in each State. Further, with only fifty model results instead of more than a thousand, the FCC would be in a position to review carefully the model results and make adjustments if necessary. In some cases, Alaska being a prominent example, the model is unlikely to reflect unique cost drivers such as roadless areas and permafrost.

Although not generally recognized, embedded costs, either based on a model or the actual embedded costs of each carrier, also involve error, i.e., they can overstate or understate the actual need for universal service support in particular cases. That is one reason why it is important that States be in a position to make adjustments to each ETC's allocation based on a case-by-case analysis no matter what the allocation methodology employed.

If the FCC determines that it does not want to use a cost model, the SAM allocation could be accomplished using alternative methods, including consideration of historical funding levels, carrier specific embedded costs, or other criteria.

A criteria for any universal service program is whether or not it is efficient, i.e. whether maximum consumer benefit is produced for the funds expended. Under the SAM approach, States would have large incentives to maximize consumer welfare by using their allocations in the most efficient way. Every dollar given to one ETC would be a dollar that could not be given to another.

2. The Rate Benchmark

A rate benchmark should be used to meet the statutory objectives for affordability and reasonable comparability established by Congress in §254 of the Communications Act. The rate benchmark could be used by the FCC in making the State allocations. It would establish an expectation that local consumers would be responsible for the costs of the local network serving them up to a level at which the price of supported services would not be affordable or reasonably comparable, as required by §254.

The level of the rate benchmark would be periodically adjusted, based on consideration of a number of factors, such as:

1. the amount of and eligibility criteria for Lifeline/Linkup support;
2. data on the penetration of supported services;
3. economic and demographic data relating to affordability, such as household income, cost of living, etc.

This last factor requires some explanation. Affordability varies across States based on economic and demographic factors such as household income and cost of living. The benchmark would be established for each state based on these factors.

An example may help to illustrate the use of a rate benchmark. Suppose, for discussion, that the FCC chooses an embedded cost model patterned on average schedules. This average schedule would estimate the embedded cost of the local network. The rate benchmark for the State would be multiplied by subscriber counts for the State to determine an expected amount of subscriber revenue for the State. This amount would be deducted from the average schedule embedded cost. The net amount of support would be credited to the State's account at USAC.

3. Jurisdictional Issues

These State allocations and the rate benchmark would be non-jurisdictional, and hence would not rely on the jurisdictional separation of revenues, plant, or expenses. All revenues, including subscriber line charges and comparable mandatory charges would be included in the rate benchmark and all costs would be included in the cost model.

4. FCC Guidelines and Review

In order to comply with the requirements of §254 and to ensure that national policy is properly implemented, the FCC must retain the authority to establish guidelines and to review State programs for compliance with the statute and the guidelines. These guidelines and the review process would be established as part of an implementation rulemaking initiated subsequent to the adoption of this package.

An example serves to illustrate the nature of the guidelines that might be adopted. Concern has been expressed by some ETCs that the SAM mechanism is not "specific, predictable, and sufficient," one of the principles established in §254(b). The FCC might decide that it would make the State allocations every five years, for example. The State's allocation would therefore be specific, predictable, and, presumably, sufficient. The guidelines might require that the States make an allocation to each ETC for the same period, conditioned on compliance with commitments made as a condition of receiving funding. ETCs that felt their allocation was not specific, predictable, and sufficient could make their case to the FCC in the context of the latter's review of the State's plan. States would be permitted to conduct annual compliance reviews and to withdraw or reduce funding if the ETC was not living up to its commitments.

B. The Transition

As everyone recognizes, universal service and intercarrier compensation reform are inextricably linked. The transition will be described on the assumption that a currently unknown intercarrier compensation reform plan is adopted before the end of the transition.

The timeline below describes a transition including six steps over four years, with the SAM mechanism taking effect in June of 2009.

Timeline for Transition to SAM Mechanism

Step	Date	Action
Step 1	December 2005	Joint Board issues Recommended Decision
Step 2	June 2006	FCC issues decisions on intercarrier compensation and universal service, including for offsets of intercarrier compensation losses from USF; Universal service distributions frozen at 2Q 2006 levels. FCC makes referral to Universal Service Joint Board to determine SAM guidelines, specification of the benchmark and amount of 2009-2014 SAM allocations to States; Joint Board issues data request to USAC
Step 3	December 2006	Joint Board issues Recommended Decision
Step 4	June 2007	First step of intercarrier compensation offset implemented; FCC issues guidelines for State plans and SAM distributions; FCC establishes benchmark and initial 2009-2014 SAM allocations;
Step 5	June 2008	Second step of intercarrier compensation offset implemented; 2009-2014 State plans and proposed SAM distributions to FCC for review, including State increment to collection mechanism, if any; FCC commences rulemakings to act in place of States that do not submit plans
Step 6	June 2009	First SAM distributions to ETCs; State increment for collection goes into effect; Third step of intercarrier compensation offset implemented in conjunction with first SAM distribution

The purpose of the transition is to:

1. phase-in the impacts of intercarrier compensation reform and the rate benchmark;
2. allow for considered and timely adoption of implementation plans by the Joint Board and the FCC; and,
3. provide time for the States to prepare their universal service plans and for the FCC to review them.

For planning purposes, an assumption was made that the Joint Board will issue its Recommended Decision in December of 2005 and that the FCC will issue its decisions on intercarrier compensation and universal service in June of 2006.

All ETC distributions could be frozen for an interim period at the level of those distributions in the second quarter of 2006. This would avoid growth in the fund.² To this base amount of universal service

²As an alternative, rural and non-rural companies could calculate their Federal Universal Service Fund entitlement using existing procedures, i.e., both the rural and the non-rural mechanisms could remain in effect for the transition period. Intercarrier compensation offset amounts would be added to these amounts.

support, offsets could be added for intercarrier compensation losses, as determined by the FCC in its intercarrier compensation order. For illustrative purposes here, it is assumed that the FCC specifies phased offsets in June of 2007-2009. Any offsets taking effect subsequent to the implementation of the SAM could be incorporated into the State allocations.

At the time that the FCC acts on the Joint Board's initial Recommended Decision, it should make a subsequent referral for consideration of implementation issues. The Joint Board would be given six months to make a further Recommended Decision describing the FCC's guidelines for review of State plans and the level of the initial SAM allocations. To accomplish this task, the Joint Board would be empowered to issue a data request to USAC, which would coordinate the collection of data from all ETCs. In this draft timeline, it is assumed that the initial SAM allocations would be for a period of five years.

In June of 2007, the FCC would issue its guidelines for review of State plans and it would also establish the initial five year SAM allocations for the States. States would have one year to prepare their plans and submit them to the FCC. The FCC would then have one year to review them and to act in the place of States that did not submit plans.

The first SAM allocations and distributions would be made as of June 2009.

APPENDIX B

Three Stage Package for Universal Service Reform Proposed by Joint Board Member Billy Jack Gregg

Universal Service deserves a fresh look in light of recent technological, market, regulatory and judicial developments. However, the Joint Board also needs to respond in a timely manner to the current FCC referral of rural support issues. Accordingly, the following package of Universal Service reforms contains three stages: one short-term stage which makes various changes to rationalize and simplify existing rural support mechanisms; a second mid-term stage which modifies the manner in which support is determined for rural carriers; and a third long-term stage which attempts to provide a unified approach to Universal Service.

Stage one of this package can be accomplished within the context of the current Joint Board referral; that is, the Joint Board can act on these proposals based on the currently noticed referral and record developed to date. Stages two and three would require new proceedings and comments in order to properly develop a record for reforming the federal high-cost support mechanism. As such, stages two and three are broad roadmaps for future action by the FCC and Joint Board in that the details will be developed at a later date. It should be noted that this package does not assume any particular reform of intercarrier compensation, but can accommodate a wide range of changes to the current intercarrier compensation regime.

STAGE ONE – Short-Term Plan

This stage would have five parts which would reform the existing support system under the current referral to the Joint Board:

1. **Combine Study Areas.** All study areas within a state owned by a single company would be combined into one study area for universal service purposes. This rule would apply to all carriers, rural and non-rural. Consolidation would occur five years after acquisition of additional study area(s), or two years after adoption of the new rule requiring consolidation, whichever is later. After consolidation, high-cost support would be based on cost data for the entire combined study area.
2. **Move Large Carriers to the Model.** All rural carriers serving 100,000 lines or more within a state would have support determined pursuant to the Commission's High Cost Model, just as it is for non-rural carriers. However, rural carriers moved to the model should not be subject to "statewide averaging" of costs currently used in the non-rural support mechanism.¹ Support for large rural carriers moved to the model would be based on the costs of that individual carrier's operations within a single state.
3. **Freeze Per Line Support upon Competitive Entry.** For those rural study areas remaining on embedded cost support, freeze per line support for the incumbent upon entry of a competitive ETC.

¹ Under the current non-rural support mechanism, the forward-looking costs of each non-rural carrier within a state are first determined by the model. The total costs of all non-rural carriers are then added together and divided by the total number of lines served by non-rural carriers within that state. See, 47 C.F.R. §54.309(a). If the statewide average costs are below the cost benchmark for non-rural carriers, then no non-rural carriers in that state receive high-cost model support. This is true even if individual carriers have per line costs above the cost benchmark. In essence, the higher costs of smaller carriers are often lost in the averaging with larger low-cost carriers within the same state. Under the proposal in point 2 above, larger rural carriers moved to the model would continue to have their support determined on an individual basis. In other words, the costs of these larger rural carriers would not be averaged in with the costs of other carriers within the state using the model.

4. **Determine Support Based on Each ETC's Own Costs.** For those rural study areas remaining on embedded cost support, base per line support on each ETC's own costs, capped at per line support of the incumbent.

5. **Extend Rate Comparability Review to Rural Carriers.** In the *Tenth Circuit Remand Order*² the FCC required states to review rates in rural areas served by non-rural carriers and certify that they were at or below the rate comparability benchmark. States with rates above the benchmark could petition for supplemental rate support. Even though the level of the rate benchmark has been remanded to the FCC for further review,³ rural customers of rural carriers should have the same protection against excessive rates as enjoyed by customers of non-rural carriers.

End Result of Stage One

1. Combination of study areas within a state under common ownership would result in recognition of efficiencies of scale and scope actually enjoyed by each carrier. Consideration of a carrier's entire operations will ensure that local switching support goes only to truly small carriers that cannot obtain such efficiencies, and should reduce the total amount of local switching support. On the other hand, this proposal would remove a barrier to sale and acquisition of rural exchanges by allowing recovery of costs associated with acquired rural exchanges after five years (or two years of adoption of rule). In other words, the "parent trap" established by 47 C.F.R. §54.305 would be eliminated. Because of their unique characteristics, Alaska and insular areas should be exempted from this requirement to combine study areas.

2. Use of the model for larger carriers should reduce the total amount of high cost support and eliminate problems with determining per line support for individual wire centers. This proposal would affect 37 rural study areas serving 10.4 million access lines. (If all study areas owned by a single company within a state are combined as proposed in point 1, an additional 57 rural study areas serving 1.6 million access lines would also be affected.) Rural carriers with study areas serving less than 100,000 lines would continue to have support determined using the modified embedded method. In other words, 94 rural study areas serving 12 million access lines (an average of 127,659 access lines per study area) would be moved to the model, while 1,255 rural study areas serving 9.5 million access lines (an average of 7,570 access lines per study area) would remain on the current modified embedded methodology of determining costs. Because of their unique characteristics, Alaska and insular areas would also be exempted from this requirement. In other words, large rural carriers in these areas would continue to use the current modified embedded cost methodology.

3. Freezing per line support upon competitive entry in study areas served by smaller carriers (less than 100,000 lines) would prevent per line support determined under the modified embedded cost methodology from spiraling to unreasonable levels as a result of lines lost to competitors.⁴ Frozen per line support would grow at rural growth factor as recommended by the Rural Task Force in 2000.

² *In re: Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Order on Remand, Further Notice of Proposed Rulemaking, and Memorandum Opinion and Order, 18 FCC Rcd 22559 (2003) ("*Tenth Circuit Remand Order*").

³ *Qwest Communications International, Inc. v. FCC*, 398 F.3d 1222 (10th Cir. 2005) ("*Qwest II*").

⁴ This problem was addressed at pages 20-21 of the Rural Task Force's White Paper No. 5 (Sept. 2000). Although a rural incumbent may lose access lines as a result of competitive entry of another ETC, it is not likely that the incumbent's total costs and, thus, total support under the modified embedded cost methodology would decline. As a result, per line support for the incumbent would increase as the number of lines decreases. If support for CETCs continues to be based on the per line support available to the incumbent, then per line support for the CETC would also rise as it takes lines from the incumbent, leading to a spiraling effect.

4. Basing embedded cost support on each carrier's own costs would prevent potential windfalls to competitive ETCs with lower cost structures than incumbents. Capping support would prevent competitive ETCs from reaping unreasonable per line support on an embedded basis simply because they serve few lines.

5. Extension of rate comparability review to rural carriers would ensure that all rural customers are protected against unreasonably high rates, regardless of changes in universal service funding and intercarrier compensation.

Adoption of the proposals contained in Stage One would stabilize the fund over the next three to five years, but allow carriers to rationalize their service areas and business plans. Combination of study areas under common ownership would eliminate switching support for some carriers, but would allow loop support to be based on actual investments made throughout a carrier's service area, including newly acquired study areas. Although the Stage One proposals would eliminate potential support windfalls to CETCs which exist under the modified embedded support system, the proposals would not address the problem of ever-increasing support for CETCs caused by supporting multiple lines of multiple ETCs within the same high-cost area.

STAGE TWO- Mid-Term Plan

Under this proposal, support for rural carriers remaining on the modified embedded cost methodology would be based on the total costs of these carriers, and would also consider the revenues received, including intercarrier revenues. As a result, the support mechanism resulting from Stage Two could accommodate whatever changes to intercarrier compensation are ultimately adopted.

1. **Base Support on Total Costs of Rural Carriers.** Currently, the three separate rural support mechanisms – High Cost Loop, Local Switching Support, and Interstate Common Line Support – look at different aspects of the costs of rural companies, but do not consider transport costs. In addition, rural carriers with high switching costs serving over 50,000 lines are not eligible for support. Stage Two would adopt a unified approach to support for rural carriers remaining on the modified embedded method, and would provide support for all types of costs incurred in providing supported services: loop, switching and transport. This portion of the Stage Two proposal is almost exactly the same as proposed in Section II.B. of the Universal Service Endpoint Reform Plan ("USERP").⁵ If the definition of supported services is expanded to include broadband, costs related to broadband could be added to the calculation.

2. **Compare Embedded Costs of Rural Carriers to Available Revenues.** The current federal support mechanisms for both rural and non-rural carriers are based on cost benchmarks.⁶ However, as originally conceived, federal support was to be based on a comparison of costs to a revenue benchmark.⁷ Under a revenue benchmark approach, the costs of a particular carrier are compared to revenues available to support those costs. If costs exceed revenues, then a certain portion of the excess costs are eligible for federal support. The unseparated costs of each rural carrier – determined as set forth in point 1 above – should be compared to the unseparated intercarrier revenues (interstate and intrastate) received by each

⁵ The USERP Plan was submitted to the FCC on July 28, 2005.

⁶ Under the current cost benchmark, two different rural carriers of similar size – Carrier A and Carrier B – with costs of \$46 per line per month – would receive the same amount of federal support. This would be true regardless of the level of local rates and regardless of the amount of intercarrier compensation received by the two carriers. Use of a revenue benchmark could result in different levels of support for these two carriers based on the amount of revenues each receives.

⁷ See, *In re: Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, First Report and Order, 12 FCC Red 8776 (1997) at ¶¶257-267. Several states also consider revenues in providing support under state USFs.

carrier plus a national revenue benchmark.⁸ The national revenue benchmark would represent the local contribution to support of carrier costs expected of all local customers throughout the nation.

As an example of how this primary support⁹ mechanism would work, refer to Carrier A and Carrier B previously cited in footnote 6. Once again, assume that each carrier has unseparated costs of \$46 per line per month. Also assume that Carrier A has monthly intercarrier revenues of \$11 per line and local revenues of \$32 per line, and Carrier B has intercarrier revenues of \$16 per line and local revenues of \$16 per line. Finally, assume that the national revenue benchmark is \$30 per line per month. Carrier A's costs are \$46 per line, minus \$11 in intercarrier revenue and \$30 in national revenue benchmark, leaving an excess of costs over revenues of \$5 per line per month. Carrier B's costs are \$46 per line, minus \$16 per line in intercarrier revenue and \$30 in national revenue benchmark, leaving no excess of cost over revenue. If the federal USF support is based on 76% of excess costs, Carrier A would receive \$3.80 per line per month in support ($\$5.00 \times 76\%$), while Carrier B would receive no support.

If intercarrier compensation reform is adopted and intercarrier revenues decline, primary support levels would also change under this mechanism. Using all of the same assumptions for Carriers A and B stated above, but assuming that intercarrier revenue for both carriers drops to \$2 per line, both carriers would receive \$10.64 per line in federal universal service support.¹⁰ Once again, the level of primary support would not be affected by the local rates actually charged by either Carrier A or Carrier B.¹¹

3. Federal Support Should Be Based on a Percentage of Excess Costs. If carrier costs are compared to available revenues, the amount of primary support should be based on a percentage of the costs in excess of revenues. This is consistent with current support mechanisms for both rural and non-rural carriers. Primary federal support should not be 100% compensatory for excess costs in order to provide an incentive for efficiency, and to provide a role for state universal service funds in achieving comparable rates.

End Result of Stage Two

1. Use of total costs of rural carriers remaining on the modified embedded support methodology would more appropriately direct support to carriers with high costs in the aggregate, not merely those carriers that are small in size. A unified approach would also include consideration of transport costs which are extremely high for some rural carriers.
2. Use of revenue benchmarks would take into consideration the level of intercarrier compensation actually received by each carrier, and would address the issue of the minimum revenue contribution expected from local customers. As a result of using a national revenue benchmark, rather than the actual local revenues of each carrier in determining support, Carrier A is not penalized because it has high local rates, and Carrier B is not benefited because it has low rates. Furthermore, there is no requirement that

⁸ The national revenue benchmark should encompass all revenues except intercarrier revenues.

⁹ The term "primary support" is used to differentiate support determined by comparing costs to revenues from supplemental rate support determined by comparing local rates to the national rate comparability benchmark. See point 5 in Stage One.

¹⁰ Unseparated costs of \$46 per line minus national revenue benchmark of \$30 per line minus intercarrier revenue of \$2 per line equals excess costs of \$14 per line for both Carrier A and Carrier B. Multiplying the \$14 per line excess cost by 76% equals support of \$10.64 per line.

¹¹ As discussed in point 5 of Stage One, carriers would, however, have recourse to supplemental rate support if local rates exceeded the rate comparability benchmark.

Carrier B increase its local rates in order to receive support.¹² On the other hand, if reforms in intercarrier compensation result in a reduction in intercarrier compensation actually received by Carriers A and B, they may both be eligible for additional federal USF support as intercarrier revenues decline. The revenue benchmark proposal doesn't presume any particular change to the intercarrier compensation regime, but can accommodate any changes actually implemented.

3. The percentage of excess costs eligible for federal support can be modified to achieve an overall level of support that is consistent with Section 254 of the Act and that is consistent with the end-result desired by policymakers. The percentage of support provided could be varied depending on the size of the carrier involved, or the relative size of excess costs, as under the current system. In other words, the percentage of support provided could increase as the line size of the study area served decreased, or as the amount of excess costs increased.

STAGE THREE- Long-Term Plan

Following completion of intercarrier compensation reform, the support system outlined in Stage Two above would transition into a unified system, based on allocations of support to the states. This proposal would encourage a fresh look at Section 254 and the requirement to preserve and advance universal service, with no preconceptions concerning maintenance of the current system.

1. **Unified System.** This proposal would seek to develop a unified system to support high-cost areas regardless of status of the serving carrier. Differences in treatment between rural and non-rural carriers, between incumbents and new entrants, and between technologies should be eliminated.

2. **Allocation and Distribution of Support.** This proposal contemplates a "block grant" system similar to the plan proposed in the "State Allocation Mechanism" (SAM) or in Section II.A. of the USERP plan. Federal support would be allocated to states, and states would be responsible for distributing funds to ETCs serving high-cost areas within their borders. Distribution of funds would be based on guidelines established by the FCC to meet the universal service goals of Section 254.

3. **Limitations on Growth in Fund.** The amount of the block grants would be adjusted annually for changes in the GDP-CPI index. After five years, the level of federal support would be reviewed and adjusted as necessary.

End Result of Stage Three

1. This long term plan would initially limit the growth in the size of the fund to growth in inflation. Future changes in the size of the fund could be considered by the FCC in a holistic manner.

2. Moving to the state grant system would stabilize the size of fund, but difficult decisions on allocating funds to different carriers and areas within each state would be transferred to state commissions. Operating within federal guidelines, states should be in a better position to know where funds are needed most.

¹² This proposal does not assume any change in local rate regulation. The ability of any carrier to change local rates would be a matter for the individual carrier and the appropriate regulatory authority. The appropriate use of USF funds received would also continue to be a matter for the appropriate regulatory authority pursuant to Section 254(e) of the Act.

3. States that designate multiple ETCs within the same high-cost area would have to deal with how to pay for those decisions, and still maintain comparable rates.

APPENDIX C

A HOLISTICALLY INTEGRATED PACKAGE

**Submitted by Commissioner Robert Nelson to
Federal-State Joint Board on Universal Service**

The package proposed herein responds to the issues in the Commission's referral to the Joint Board (CC Docket No. 96-45). It contains elements of the various packages previously submitted by Board members (Billy Jack Gregg and Commissioner Baum) as well as elements from the Universal Service Endpoint Reform Plan (USERP) submitted by Staff members Bluhm, Shiffman and Parsley. In addition, it relies heavily on the Intercarrier Compensation proposal submitted as part of the record by the NARUC Task Force chaired by Commissioner Elliott Smith. Although it may be argued that some of the elements of this package are beyond the scope of the referral, the package attempts to keep within the parameters of the referral and addresses each of the issues presented in the Options Memo circulated by Staff on April 13, 2005. As such it attempts to integrate the various elements of the options memo into a holistic proposal.

I. BLOCK GRANTS/ STATE ALLOCATION MECHANISM

Although the issue of block grants is the last of the issues outlined in the Options Memo, it is critical to the resolution of other issues presented in the Options Memo. Block grants have been advanced as a possible alternative to the current distribution methodology for the High Cost Fund, as long ago as April, 2000 (See "Cooperative Federalism: The State Perspective", Inaugural Telecommunications Policy and Law Symposium, Michigan State University Detroit College of Law). Although "block grants" is the term used in the Options memo, the NARUC Intercarrier Compensation Proposal (NICP) contains a similar concept, the State Allocation Mechanism, which more closely comports with Section 254 of the Federal Telecommunications Act (FTA) than a true block grant. That concept is adopted in the Holistically Integrated Package (HIP).

The State Allocation Mechanism (SAM) would be administered pursuant to FCC guidelines and with continuing FCC oversight and would therefore not be an impermissible delegation of authority. Moreover, it embodies the spirit of cooperative federalism that is the hallmark of Section 254, as recently reaffirmed by the 10th Circuit in Qwest II, 258 F.3rd at 1203. Under the HIP proposal, the FCC's guidelines would address both how to determine what each state receives for the SAM, and, in general, how each state would allocate its disbursements within the state. Unlike certain packages however, the HIP would leave the states with more discretion to distribute the funds in accordance with the guidelines. For example, State A could distribute SAM funds to ETCs, in accordance with FCC guidelines, but may determine that more than one carrier could be funded in a given rural area, while State B could determine that only one carrier could be funded in a similar rural area. Additionally, if a state wanted to extend the transition period for certain small carriers (e.g., less than 5,000 access lines), it could do so. This discretion is consistent with Section 102(2) of the FTA, with regard to ETC designation and rural exemptions. The FCC guidelines would spell out the factors a state could consider in making its distributions (embedded costs, forward looking costs, Lifeline/Linkup participation) but each state would determine the amount each carrier receives, provided that the permanent rate benchmark proposed in the NICP (125% of the national urban rate) is honored.

Like certain other packages, the HIP proposes that the SAM would take effect after a three year transition period. During the transition period, rural carriers would be held harmless and receive at least as much high cost support as they did during 2004 provided that states certify that the fund is being used for the purposes intended. The states would have authority, during the transition period, to find that a given carrier should receive less high cost support than what historical levels provided, if the carrier's earnings levels were unreasonably high or if service quality deteriorated below acceptable levels. In addition, the states, with the Commission's review, could adopt a "best practices" benchmark, as proposed by Dr.Selwyn, to further control the size of the fund. The HIP proposal is more consistent with the NICP than is the USERP, which provides for a decrease in hold harmless funding in years two and three of \$1

per switched line. Although this provision of the USERP is designed to avoid rate shock, other means to achieve this objective (capping SLC increases, etc.) could be used.

States are in a better position to ensure that USF funds are distributed to where they are needed because they are close to the customers and can provide the day-to-day oversight that is necessary to monitor potential abuse. Moreover, it is vitally important to provide a predictable support mechanism for carriers. Higher cost and potentially risky infrastructure investment will not take place at appropriate levels if carriers cannot predict with a level of certainty just which investments will be supported through USF money. Rural companies are especially vulnerable, facing risks unlike their urban counterparts. Rural carriers face unique construction/networking challenges with a lower subscription population and a lower price change tolerance, leaving them less margin for financial error. States need the flexibility to address the unique circumstances of rural carriers.

II. DEFINITION OF RURAL CARRIER

The HIP adopts the principle advanced by the NICP that support for high cost rural areas should not be based on whether that area is served by a “rural” or “non-rural” carrier. Accordingly, the issue of how to define a rural carrier, after the transition period, becomes moot because all carriers serving rural areas would be eligible for support.

During the transition period, support would be provided in accordance with the hold harmless provisions detailed above (Section I). For those states that opt-out of the SAM, there would be continued reliance on the existing definition of rural carrier.

III. COST BASIS OF SUPPORT AND CALUCLATION OF SUPPORT

The FCC referral includes a request to consider whether having support for rural carriers based on statewide average costs is more consistent with Section 254 of the Federal Telecommunications Act than

the current study area approach. (Par. 44) In the options memo prepared by Staff, the issue of the use of statewide average costs for rural carriers for determining support is presented (Section III, Issue 2, Option 2). Since the HIP adopts the principles that states should be given discretion to allocate USF funds and support should be based on the characteristic of the study area and not the carrier, the combination of study areas is a logical extension of these principles. The USERP makes a compelling case for calculating the high cost support amounts based upon the aggregated characteristics of all carriers in a state as well as combining all existing high cost support (loop, switching, safety net, etc.) into one program. Although it has been argued that combining study areas will make support "less explicit", the advocates of that position seem to assume that the Commission will continue to use the existing distribution formula for the HCF. However, the adoption of the SAM, with the limitations provided for in the HIP, will allow states to ensure that support is provided where it is needed. Eventually, the use of statewide average costs can provide an incentive for investment in rural facilities. During the transition, reliance on study areas for calculation of support can continue, enabling rural carriers to provide the level of service they have provided in the past.

Combining study areas and existing programs in a holistic manner allows each state to better control the growth in the total USF. The package proposed by Billy Jack Gregg assumes that adopting a unified approach in this way may be outside the scope of the referral, but it is a concept that is incorporated in Stage Two of his plan. The referral, by asking broadly about the use of statewide average costs (Para. 44) and the need to merge various components of the high cost fund (Par. 47), specifically permits the adoption of the USERP proposals. If issues of statewide averaging and merging of component parts of the high cost fund are not considered in this referral, they may not be revisited by the Joint Board for many years.

IV. SUPPORT FOR TRANSFERRED EXCHANGES

The referral specifically asks whether Section 54.305 of the Commission's rules should be retained, modified or repealed. In keeping with the holistic and integrated nature of the HIP, Section 54.305, which provides limits on high cost funding available to an acquiring carrier based on the historical level of support provided prior to the acquisition. Since the HIP proposes that the distinction between rural and non-rural carriers be eliminated (See II, above), compliance with Section 54.305 would not be necessary. Accordingly, it should be repealed. If acquisitions occur during the transition period, the provision of safety valve support should be continued through the duration of the period.

V. CONTRIBUTION METHODOLOGY

Although the referral does not specifically address the contribution methodology for the USF, the NICP does. It provides for expansion of contributions through the use of a connections, bandwidth or numbers based approach (Section II. #3). The HIP includes such a recommendation. It is imperative that, regardless of the scope of the referral, that all carriers that utilize the public switched telephone network be required to contribute to the USF as soon as possible. The dramatic decrease in traditional long distance wireline traffic and the increase in the use of VoIP and the deployment of IP networks has changed the dynamics of USF so irrevocably that immediate attention to the issue is required. Consideration of the expansion of contributions is necessary to continue to provide the support contemplated in the rest of the HIP

SUMMARY

The Commission's referral seeks comment on whether to reform the rural HCF support mechanism. The mechanism cannot be viewed in a vacuum. The time has come to consider the integration of the rural HCF, the non-rural fund, the impact of intercarrier compensation and contribution methodology holistically. By recommending a package like HIP, including a SAM, the Joint Board can allow states,

pursuant to FCC guidelines, to control the USF while continuing to provide support to areas where it is most needed.

APPENDIX D
PACKAGE ON UNIVERSAL SERVICE REFORM
"UNIVERSAL SERVICE ENDPOINT REFORM PLAN" (USERP)
Proposed by Joel Shifman, Peter Bluhm and Jeff Pursley

OVERVIEW

This plan has two main components. The first addresses support for wireline Incumbent Local Exchange Carriers ("ILECs"), principally by increasing reliance on state commissions to achieve the goals set forth in section 254. The second component proposes a new method for allocating universal service funds to competitive Eligible Telecommunications Carriers ("ETCs").

FUNDING FOR WIRELINE IN HIGH-COST AREAS

The State Allocation Mechanism

USAC would still calculate support amounts to incumbent local exchange carriers and would continue to disburse funds to carriers; but the state commission in each state would determine allocations to carriers within that state. State commissions would have what amounts to a power of appointment (or allocation) over federal high-cost funds. States would also be responsible for ensuring that wireline carriers receive sufficient support so that the rates in all wirecenters do not exceed a benchmark amount. States would also determine the purposes to which funds are applied.

The plan anticipates that support to carriers would come from a mix of state and federal universal service funds. While this plan creates incentives for states to create their own universal service funds and raise rates to a federal benchmark, it does not require states to do so. States may face more pressure to increase explicit support in some areas where competition is making continued rate averaging impracticable. This role for state commissions is consistent with the Act. The Act gave states significant responsibility to act as partners with the FCC in achieving national universal service goals. State commissions would retain all current jurisdiction (if any) over local exchange rates. For this reason, the plan assigns primary responsibility for universal service to the agency that has the most oversight over end-user rates, and states would be primarily responsible for rate differences within their boundaries.¹ Federal support ("Part I") would be provided where average costs are so high that the state cannot attain comparable and affordable rates through its own efforts. A second form of federal support ("Part II") would be provided where a state needs to make extraordinarily large efforts to equalize the differences within its own boundaries.

The following sections discuss how costs would be measured under the plan, how the FCC would allocate support totals to the states, and how the states would sub-allocate that support to carriers.

Costs

The plan would be primarily cost-based, although costs would be adjusted for intercarrier revenues. To determine costs, the plan would look generally at "embedded" or accounting cost,² and would calculate

¹ Additional federal responsibility in this area is an option explained below.

² As noted below, for certain purposes, where existing records are not sufficient to allocate costs to areas smaller than study areas, overall costs could be allocated among wire centers using forward-looking cost models.

what amounts to a revenue requirement for plant, depreciation, return and operations. This choice should maintain current incentives for continued network investment.³

Nevertheless, costs would be limited in ways that reduce incentives for wasteful spending. This could be done with the cost outputs of a "forward-looking" costs model⁴ or with "best in class" standards.⁵ Limitations would be imposed in cost or investment areas where abuse is suspected and where imposing the cap would not unduly harm investment incentives.

The plan would look comprehensively at all categories of ILEC costs, including loop, ports, switching and transport.⁶ Costs would also include all operations, including network operations, customer service operations, and corporate operations. Costs will be considered on an aggregate basis; and a low cost in one category will offset a high cost in another category.

This contrasts with current support programs. For rural carriers, current programs look only at specific cost components, such as switching⁷ or loops, and they do not include any costs for tandem switching or interoffice transport.⁸ For nonrural carriers, the Model Based Support Program includes loop costs, plus some local switching and local transport costs. It does not include the costs of all local and tandem switching nor all transport costs.⁹

The plan also provides support for costs in both jurisdictions using a unified approach. Therefore, it replaces not only programs now supporting intrastate costs, but also programs such as IAS and ICLS that support interstate costs.

Federal Support To States

Federal support to each state might come in two forms, as described below.

Part I Support

Federal "Part I" support is designed to continue the FCC's policy of maintaining affordable and comparable rates among states. Support would be calculated based upon the aggregated cost

³ While the plan would use embedded cost as the primary inputs for support calculations, the support mechanism described below would also work if the Commission were to use forward-looking costs.

⁴ For example, feeder and loop investment, and switching investment, could be limited to 125% of the output of a forward-looking model. Exceptions might be needed in areas where the model is not likely to take account of all cost factors, such as in permafrost areas or areas not served by the general road network.

⁵ For example, corporate operations expenses are currently capped for the High Cost Loop Program based upon industry average costs. A revised cap of this sort might impose stricter limits based upon a class of low-overhead companies. Dr. Lee Selwyn suggested this approach at the Joint Board's hearing on Universal Service on June 7, 2005.

⁶ Incremental costs of vertical services would be excluded.

⁷ Although local switching costs are supported by the Local Switching Support Program, that support is not determined on the aggregate level of those costs, but upon study area size, which does not always predict switching cost.

⁸ Since this plan provides universal service support for high transport and tandem switching costs, it reduces the burdens on NECA pools and intercarrier compensation recovery. This may simplify the task for intercarrier compensation reformers.

⁹ Some of these excluded costs are recovered through intercarrier compensation and, for some companies, the NECA pooling process.

characteristics of all incumbent carriers in the state and provided to states with high average costs. This would effectively assign states the principal responsibility for universal service support within their own borders.

This averaging policy is consistent with that used now for nonrural carriers (although it does not use a forward-looking cost model). It would be a change, however, for rural carriers, whose support is now separately calculated for "study areas" without any regard for costs elsewhere in the same state. Section 254 speaks to "rates." The plan would equate rates with the average unit revenue requirement that a carrier must recover from its customers ("Consumer Cost"). The plan assumes this is equal to the difference between the carrier's total cost and its inter-carrier revenues.¹⁰ To manage customer rates, federal support therefore would manage the carrier's "Consumer Cost."¹¹

The plan would set a benchmark standard to ensure that Consumer Cost is affordable and reasonably comparable. A "permanent benchmark" would be set at 125 percent of the national average urban cost (net of intercarrier revenue).¹² Support to each state would be sufficient to keep this cost at or below the benchmark everywhere in that state.¹³ This provides a functional definition of "affordable" and "reasonably comparable" rates. The effect would be that, after federal support has been received, average Consumer Cost would be, in every state, no higher than the benchmark.¹⁴ Except during a transitional period, the plan does not provide more support than is necessary to achieve affordability and comparability. Specifically, no state should have so much federal support that it could set some rates (which reflect Consumer Cost) below the benchmark and still have enough federal support to keep other rates from rising above the benchmark.¹⁵

¹⁰ Billing and collection revenues would be treated as intercarrier revenues.

¹¹ The equation expressing this is:

$$\text{Consumer Cost} = \text{Gross Cost} - \text{Net Intercarrier Revenue} - \text{Universal Service.}$$

Gross Cost would be determined as described in the preceding section, and might exclude some plant or expenses associated with unregulated services.

¹² This benchmark is significantly lower than that rejected by the Tenth Circuit in *Qwest II*. In that case the court rejected a *rate*-based standard of 138% of the national urban *rate*. However, the FCC had used a *cost*-based benchmark of two standard deviations to actually distribute support. Neither the court nor the FCC made findings about how this cost benchmark related, as a percentage, to either national average cost or to urban average cost. The court did find, however, that the FCC had not demonstrated that there was any record support for its "pairing of rates to costs."

As noted in the main text, the plan sets a standard of 125% of urban average cost, net of intercarrier revenue. In the third quarter of 2005, USAC is using a cost-based benchmark (\$28.13) equal to 131% of the national average cost (\$21.43). For two reasons these percentages cannot be directly compared:

- 1) The 131% is a multiple of *average* cost, but the 125% is a multiple of *urban* cost. The FCC has never made any finding about urban average cost, so it is not possible to convert the one standard to the other without additional findings.
- 2) The existing mechanisms are not adjusted for inter-carrier revenues.

¹³ Support would be equal to the following, with all terms defined on a per-line, per-month basis:

$$\text{Federal Support to State} = \text{State Average Cost} - \text{Net Intercarrier Revenue} - \text{Permanent Benchmark}$$

¹⁴ As discussed in the following sections, internal cost variations within a state would be a matter primarily of concern to that state.

¹⁵ As discussed below, any state with low rates and costs in some areas might need to have a state universal service fund under subsection 254(f) to avoid violating section 254.

Part II Support

The second support program recognizes that state USF charges are themselves a part of "rates," and that state USF programs can impose significant burdens on urban ratepayers, in violation of the principles of section 254. Part II support would be provided to states in which an explicit high-cost fund would impose an undue internal burden on state ratepayers, but only to states that actually have explicit USF programs.

Because states with substantial rural areas would have the greatest burden of support, Part II support would be available in those states with the highest proportions of high-cost customers. Part II support would be calculated without any direct reference to the state's average cost, and would be available without regard to whether the state also received Part I support. Any Part I support, however, would offset Part II support.

To calculate the internal burden imposed by a state USF program, Part II support would make standardized assumptions about state USF effort. It would assume that the state has been divided into three zones, corresponding to the UNE zones existing in most states. These zones are customarily called "urban," "suburban," and "rural."¹⁶ The plan also assumes that the state provides support to customers in each zone based on the average cost in that zone and using a uniform benchmark that is equal to the benchmark used for Part I support. Imputed state support to each zone is then calculated and summed. The required contribution level of state telecommunications customers is then calculated. If that required contribution level exceeds \$2.00 per month,¹⁷ then Part II support would make up any difference not already covered by Part I support.¹⁸

Hold Harmless and Separations

Transition to the new plan would be gradual through use of a declining hold-harmless mechanism. In the first year, hold-harmless support would equal the support received by the state in the previous year. Each year thereafter, hold-harmless support to the state would decrease by \$1.00 per month per switched line until the hold-harmless provision no longer had any effect. This provision allows the state commission to transfer federal support gradually to more needy areas and to implement state USF funds (where necessary), but without creating a risk of rate shock.

The plan is "omni-jurisdictional" because it does not rely on traditional separated costs. First, the new program would replace all existing universal service programs, regardless of the nature of the costs they currently support. Specifically, the plan would replace High Cost Loop Support, Local Switching Support, Safety Net Support, High Cost Model Support, Interstate Access Support, and Interstate Common Line Support. Second, the support calculation would consider costs on a total or "unseparated" basis.¹⁹ Third, the plan is indifferent to the jurisdiction of revenue. For intercarrier revenue in particular, the plan is not concerned about whether that revenue is derived from intrastate or interstate traffic.²⁰

¹⁶ By aligning the boundaries of UNE zones with USF calculations, opportunities for arbitrage can be eliminated.

¹⁷ Wireline and wireless lines would both be counted. This calculation does not presume that the state would actually collect revenue on a per-line basis.

¹⁸ An illustrative calculation of Part II support is attached in spreadsheet form.

¹⁹ This is true today for the High Cost Loop and High Cost Model Support programs.

²⁰ Separations would formally continue, but as is true today with "Average Schedule" companies, jurisdictional separations would be determined by the jurisdictional nature of revenues. For example, if 30% of revenues are interstate, a total company separations methodology would assign 30% of costs to interstate.

State Allocations of Support

States would have first-line responsibility to ensure that all customers have rates that are affordable and comparable. In many cases, federal support and retail rate averaging would be sufficient to achieve this goal. In other cases, explicit state universal service programs would be needed. The following four cases illustrate how state and federal funds would interact.²¹

- Case 1: Uniform low cost. This state would not receive any Part I or Part II federal support. Since Consumer Cost is already below the benchmark, universal service objectives can be achieved without any federal or state USF programs.
- Case 2: Uniform high cost. The plan would provide Part I support so that, if it is well distributed to all carriers, each carrier would have an average Consumer Cost below the benchmark and each customer would have a rate that is affordable and comparable.
- Case 3: High but varying cost everywhere. This case is more probable. Federal Part I support would still come to the state, since its average cost is high. Compared to Case 2, however, the allocation task for the state commission is more complex, and different carriers will be allocated different amounts of federal support. The end result, however, is the same as Case 2: each carrier would have an average Consumer Cost below the benchmark and each customer would have a rate that is affordable and comparable.
- Case 4: Some high cost, some low cost. This is the most probable case. Because some customers have low cost, Part I support would not be sufficient to produce everywhere a Consumer Cost below the benchmark. Instead, the state would need to establish a state universal service fund under section 254(f).²² That state program would impose a charge in all areas, including low-cost areas. The charge would raise effective rates everywhere, but the support it produces would reduce costs in high-cost areas. If the imputed state USF charge rises above \$2.00 per month, Part II support would also be provided to the state.²³

In all four cases the final results should be the same: average Consumer Cost for each carrier would be below the benchmark, and each customer would have an opportunity for a rate that is affordable and comparable.

State distribution decisions would be subject to some limitations. First, distributions should be sufficient to ensure that rates can be just, affordable and – because they are no higher than the permanent benchmark – reasonably comparable to urban areas nationwide. Second, support to an ILEC would not depend on whether the ILEC is classified as a “rural telephone company.” Third, distributions should be predictable and should be based on published data and explicit and predetermined calculations.

Fourth, state distributions to carriers would be constrained by declining hold-harmless protection. Each year, hold-harmless support to any carrier might decrease by \$1.00 per month per switched line. This would allow the state commission to transfer federal support gradually to more needy areas and to implement state USF funds (where necessary) while minimizing rate shock.

Except for these four limitations, state allocations would be discretionary. States could assign support to particular carriers, study areas or exchanges. They could also condition support funds on particular uses,

²¹ In the examples, “low cost” means a Consumer Cost below the benchmark, and “high cost” means a Consumer Cost above the benchmark.

²² We discuss below an optional mechanism to use when the state fails to take this action.

²³ Where a state cannot implement a state universal service program (such as because of a lack of state law authority), the FCC may have to substitute for the state and operate this portion of the program directly.

such as requiring the carrier to meet broadband deployment targets in particular exchanges. Each state would annually notify USAC and the FCC of its allocation plan.

State commissions would be required to file annual reports with the FCC, concurrent with the annual ETC certifications now filed in September. The reports would allocate support for the upcoming year to ETCs. The reports would also include:

- A section 254 compliance report, including the results of rate comparability surveys, conducted according to a prescribed method, and including an evaluation of the success of state and federal programs in achieving affordable and reasonably comparable local exchange rates.
- An accountability summary explaining how federal funds have been and are likely to be used by carriers to promote universal service, including the results of any company audits or “agreed-upon procedure” reviews that the state requires from ETCs.
- A broadband report describing the state’s broadband deployment goals and summarizing progress toward those goals.

Any carrier or customer may petition the FCC to review whether a state’s support allocation decisions have been sufficient to produce affordable and comparable rates.

Rural and Nonrural

The plan would apply to all companies, rural and nonrural.²⁴ This would be an effective means to address issues raised in *Qwest II* and would eliminate the present pattern that rates and support can depend on the type of carrier that owns an exchange, rather than on whether that exchange is rural or high-cost. This would also eliminate the so-called “parent trap” problem under which support levels are controlled by the history of which exchanges were controlled at particular times by which kinds of carriers.

The plan could conceivably be applied solely to rural companies.²⁵ That choice, however, has disadvantages. Most important, it would treat rural areas differently based upon the identity of the carrier that serves it. This choice would also leave unresolved the sufficiency of federal support to non-rural carriers, a matter that must be addressed following *Qwest II*.

Non-Participating States and the Federal Overlay

Some states have low average Consumer Costs, but also have some very high-cost areas. Implicit intra-company transfers are currently large enough in most of these states to prevent unaffordable or non-comparable rates. Some low or moderate cost states, though, will need to adopt supplemental state universal service programs. The act does not require that any state adopt a subsection 254(f) programs, and the FCC probably cannot mandate such state programs under existing law, even if the Joint Board and the FCC think they would be useful. As a result, some states might not do enough, in the judgment of the Joint Board, to meet their responsibilities under section 254. The Act does not clearly provide a judicial remedy to individual customers in this circumstance. The FCC may have to provide a remedy since it is the FCC that has ultimate responsibility for compliance with section 254.

One option would be for the FCC to operate what amounts to a state-specific universal service program in those states that do not establish a state program on their own. This would require the FCC to establish a supplemental universal service charge that applies only in one state. Revenues from this supplemental

²⁴ This choice might exceed the scope of the current referral to the Joint Board.

²⁵ This would leave in place some existing universal service programs that apply to nonrural carriers, including the High Cost Model Program and Interstate Access Support.

charge, together with any support otherwise due to the state, would then be allocated directly by the FCC to carriers. In these cases, the state would not exercise its normal role in establishing state programs and in allocating federal support.

In states with such a federal overlay, all customers would pay a higher total federal USF charge higher than is paid by customers in other states. However, because the additional proceeds would defray costs in high-cost areas, the net effect should be that all customers in the state have affordable and comparable rates.

COMPETITIVE ETCs

The plan would restructure support to Competitive ETCs, making the most significant changes with regard to wireless CETCs.

The current universal service fund provides portable support to CETCs based on ILEC support. It also increases per-line support to ILECs as they lose customers. This can have the overall effect of financing competitive CETC networks with universal service.²⁶ The plan does not fully address that problem, which is rooted in the portability rules. Although the suggestions below should slow the growth of the fund's CETC payments, more fundamental policy changes would be needed to fully insure the universal service fund against growth of this kind.

Wireless CETCs

Wireless CETCs would no longer be funded by "portable" universal service support that is based on the costs of incumbent wireline carriers. This policy change reflects the fundamental cost, regulatory and rate differences between wireless and wireline service. There are also functional differences that limit substitution of one service for the other.

Wireless and wireline networks have different cost characteristics. First, the geographic scales are different. For wireline networks, costs are largely determined at the wireline exchange or "wire center" level, and those costs control USF support. By contrast, wireless costs are primarily incurred over areas served by antenna towers, which can be larger or smaller than wire centers. Second, building density is the most significant cost driver for wireline networks. Wireless networks also serve travelers, particularly along highways, allowing for cost recovery from customers who live elsewhere. Third, wireless services are not subject to the same regulatory requirements as wireline companies. Equal access, service quality standards, tariffing, and regulatory reporting requirements all add cost to wireline operations. Providing support to wireless carriers based on wireline costs creates opportunities for financial windfalls.

Wireless rates also operate at a different geographic scale. For most wireless carriers, rates do not vary locally or even across state lines. Further, wireless rates and rate structures differ from traditional wireline. As a result, using common benchmarks for both wireline and wireless services may not accomplish the goals of universal service. While universal service support to wireless carriers may create incentives for these carriers to expand their coverage to unserved areas, that support is unlikely to have an effect on the affordability or comparability of wireless rates.

²⁶ For example, consider a rural ILEC whose territory has been overbuilt by a neighboring CLEC. As the competitor gains lines, the rural ILEC's overall support would not ordinarily decrease, because its loop and switching costs would not decrease. Rather, the ILEC's total support would remain relatively constant despite a shrinking customer base, and its per-customer support would increase. Under the portability rule, this would increase per-line support for the CLEC. In the simplified case where the carriers equally divide the market and each has the same per-line cost, the net effect could be that universal service support would not change for the ILEC but would pay all or nearly all the cost of constructing the CLEC's overbuild. If the CLEC should obtain more than a 50% market share, universal service could pay more than the total cost of the CLEC's network.

Wireless services can perform functions not possible for wireline service. Nevertheless, most customers do not yet consider wireless to be a full substitute. Although the substitution rate is increasing, most customers still consider wireless to be a different service that supplements their landline service. The effect of providing universal service to wireless under these circumstances therefore is to support construction of a second, parallel network.

Under the plan, wireless CETCs would instead be funded through a separate "Portability Fund" that would be available only to wireless carriers. The goal of the fund would be to substantially improve wireless coverage in unserved areas, with a particular emphasis on unserved areas with major roads.²⁷ The Portability Fund would be capped at \$1 billion per year. This is more than the projected \$800 million CETC support projected for 2005, but substantially less than the approximately \$1.8 billion that the wireless industry contributes to USF.

The Portability Fund would extend for five years and would then sunset. As the sunset date approaches, the Joint Board would review the program and assess whether the Portability Fund should be extended for an additional term.

As with wireline support, the first step in administering the Portability Fund would be to allocate money to the states. Federal allocations would be made based on a combination of factors including the size of unserved low-density areas, public safety needs and the probable call volumes from incrementally serving new areas.

State commissions would then sub-allocate their funds to CMRS carriers using a competitive grant method. State commissions would request proposals from CMRS carriers to provide additional coverage in unserved areas and unserved roads.²⁸ The state commission would then award federal grants for construction of additional facilities. The grantee would be required to show thereafter that all funds had actually been properly expended.

Other Competitive ETCs

The plan would continue the present portability policy for wireline CETCs of basing support on ILEC costs, but the scale of measurement would change. Under the plan, each incumbent's costs would be disaggregated below the wire center level. Each rural wire center would have two or more disaggregation zones, at least one devoted to the city, village or town center. In rural areas, a "rural doughnut" surrounding this core would also be defined; and it ordinarily would have higher costs and be entitled to higher support.²⁹ To simplify the support calculation, several rural "doughnut" zones could be aggregated into a single rural class.

The plan would also require some changes to UNE pricing. UNE prices would be deaveraged using the same disaggregation zones that are used for determining support to CETCS.

²⁷ Roads through designated wilderness areas might be excluded from eligibility.

²⁸ If it appears that relatively few areas and roads are unserved, the commission could identify areas with service from only one CMRS carrier and use the funds to establish a second provider's signal.

²⁹ By the time this plan can be implemented, one or more states may have already filed disaggregation plans based upon sub-wire-center disaggregation. In those states, no new disaggregation plan would be needed.